No. 13700

In the United States Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

RALPH E. HEDGES, RESPONDENT

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

STANLEY HEDGES CHILDRESS, PETITIONER

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

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FILED

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 50-61)[1] are reported at 18 T. C. 681.

JURISDICTION

The petitions for review filed by the Commissioner (R. 60-71) relate to asserted deficiencies in individual income taxes for the year 1944. Notices of deficiencies were mailed to the taxpayers on April 17, 1950. (R. 10-11.) The taxpayers filed petitions for redetermination with the Tax Court on June 26, 1950, and July 10,

[1] Since the facts in these cases are in all material respects the same, by stipulation (R. 77-78), only the necessary parts of the record in *Commissioner* v. *Stanley Hedges Childress* are included in the printed record.

1950 (R. 3-9), under the provisions of Section 272 of the Internal Revenue Code. The decisions of the Tax Court, which failed to sustain the Commissioner's deficiency determinations, were entered on August 14, 1952. (R. 64-65.) The cases were brought to this Court by petitions for review filed by the Commissioner on November 12, 1952. (R. 75.) The jurisdiction of this Court is invoked under Section 1141(a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

While serving as administrator of the estate of his first wife Kitty, John Hedges appropriated 7,100 shares of Sunshine Mining Company stock which would have, but for his wrongful conversion, passed to the taxpayers as heirs of Kitty. The question is:

Whether the Tax Court erred in holding that the $57,439 paid to each of the taxpayers by the executrix of John's estate as a substitute for dividends for the years 1927 to 1944, inclusive, erroneously paid to John was taxable income to them under Section 22(a) of the Internal Revenue Code in the year of receipt, 1944.

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the statutes and Regulations are set forth in the Appendix, *infra*.

STATEMENT

The now pertinent facts, as found by the Tax Court (R. 51-55), are as follows:

The taxpayers filed their income tax returns for 1944 with the Collector of Internal Revenue for the District of Washington. Each used the cash receipts and disbursements method of reporting his income. (R. 51.)

John T. Hedges and Kitty J. Hedges were married in 1888. They moved to Yakima, Washington, about 1902, and resided there until they died. They had two children, the taxpayer, Ralph E. Hedges, born in 1896, and Ruth Hedges Childress, who predeceased her mother and left as her only surviving issue the taxpayer, Stanley Hedges Childress, born July 29, 1916. Kitty died intestate on March 23, 1923. John became her administrator in October, 1923. (R. 51.)

The community property of John and Kitty, as listed by him in the administration of Kitty's estate, had an appraised value of $36,429.17. A distribution of one-fourth of the assets to Ralph, one-fourth to Stanley, and one-half to John was ordered on October 4, 1924. John was awarded a fee of $1,200 as administrator of Kitty's estate and was discharged as administrator on October 4, 1924. (R. 51-52.)

The community property of John and Kitty at the time of her death included 14,200 shares of Sunshine Mining Company stock. Some of those shares were in Kitty's name, but John had all shares transferred to his name shortly after Kitty's death. John did not list any of the Sunshine Mining Company shares as assets or otherwise mention them in the administration of Kitty's estate. Ralph and Stanley were each entitled to 3,550 of those shares upon the death of Kitty as her heirs, and John was entitled to 7,100 of those shares as his portion of the community property. (R. 52.)

John executed on January 12, 1924, what proved to be his last will, the first paragraph of which was as fol-laws (R. 52.):

> Realizing that my son, Ralph E. Hedges, has or will come into possession of practically one-quarter

> of such estate as I have created, prior to the making of this, my Will, and is therefore suitably provided for, I hereby give and bequeath unto my said son Ralph, the sum of Five ($5.00) Dollars.

He left the remainder of his estate to Jessie Ames Belton, whom he married on April 5, 1924. John asked Jessie at the time he married her never to let Ralph know that Kitty and John had owned the Sunshine Mining Company stock and said he did not have to declare that stock in the inventory of Kitty's estate because it had no value. John died on February 1, 1944, survived by Jessie and the two taxpayers. (R. 52-53.)

The dividends attributable to 3,550 shares of the Sunshine Mining Company stock from 1927 to 1944, inclusive, aggregated $57,439. (R. 53.)

The taxpayers learned for the first time after the death of John that the community property of Kitty and John at the death of Kitty had included shares of Sunshine Mining Company stock and that the number of those shares was 14,200. Each taxpayer filed a claim against the estate of John, setting forth the fact that John had not disclosed the ownership of the 14,200 shares of Sunshine Mining Company stock in the administration of Kitty's estate and had thereby deprived each of the taxpayers of the 3,550 shares of that stock to which he was entitled in the distribution of that estate. They also set forth that dividends in the amount of $57,439 had been paid on each block of 3,550 shares during the time it had stood in the name of John and each taxpayer was entitled to have turned over to him 3,550 shares of the stock, $57,439 representing the dividends thereon, and six percent interest on the dividends from the date of declaration. (R. 54.)

John still held the stock at the time he died and his estate contained sufficient funds to make proper restitution to the two taxpayers. Jessie, as executrix of John's estate, knew that the taxpayers were entitled to the stock and the dividends and, with the approval of the Court, turned over in 1944 to each of the taxpayers 3,550 shares of Sunshine Mining Company stock and cash or other property in the amount of $57,439 which the two taxpayers agreed to accept in full settlement of the amounts due them. (R. 54.)

Dividends on all of the shares of Sunshine Mining Company stock standing in the name of John were reported on his income tax returns for the years 1934 through 1943, inclusive, except that the record does not show whether or not they were reported on his return for 1936. The record does not show whether or not John reported the dividends for the years prior to 1934. (R. 54-55.)

Ralph paid legal expenses of $21,000 in 1944 in connection with the recovery of the shares of stock and the $57,439 from the estate of John. (R. 55.)

The Commissioner, in determining the deficiency against Ralph, added $42,780.67 to the income shown on the return and explained that $57,439 received in 1944, in settlement of the claim against the estate of John, constituted taxable income and that (p. 55)—

> the $21,000 of legal expenses incurred by you in 1944 was incurred in part for the recovery of capital and in part for the recovery of income and that deduction is allowable only to the percentage that $57,439.00 bears to $82,289.00, the total of income and capital recovered.

The Commissioner, in determining the deficiency against Stanley, added $57,439 to income with the explanation that it represented taxable income received in settlement of a claim filed against the estate of John. (R. 55.)

The Tax Court, four judges dissenting, held that the $57,439 received by each of the taxpayers in satisfaction of his claim for dividends was not the receipt of taxable income in 1944 or any other year. (R. 60-62.)

STATEMENT OF POINTS TO BE URGED

The detailed statement of points filed by the Commissioner (R. 72-73) may be summarized as the following general proposition which will be the basis of our argument:

1. The Tax Court erred in failing to hold that the $57,439 which both taxpayers received in settlement of the claims they filed against the estate of John Hedges for dividends erroneously paid to John was taxable income to them in the year of receipt, 1944.

SUMMARY OF ARGUMENT

For tax purposes, the period of administration is, under Section 29.162-1 of Regulations 111, the "time actually required" to perform "the ordinary duties pertaining to administration." Among the "ordinary duties pertaining to administration" there is not a duty upon the administrator to seek redress from himself for breaches of his fiduciary duties. Therefore, contrary to the holding of the Tax Court, the period of administration of Kitty Hedges' estate was closed for tax purposes when John Hedges was discharged as administrator by the state court in 1944 though John had not obtained redress from himself for appropriating stock belonging

to the estate. Nor is a constructive trustee a fiduciary within the meaning of Sections 161 and 162 of the Code. Under no theory then were the dividends received by John taxable to him as a fiduciary in the years received.

It seems clear that the dividends from the stock were not taxable to John individually since he had no right to them and did not receive them with the knowledge and consent of the true owners, the taxpayers. However, even if they were taxable to him, it would not alter the fact that the amounts taxpayers received in 1944 as a substitute for dividends constituted taxable income to them in that year. The sums representing dividends were gain to the taxpayers on the cash basis in the year of receipt.

ARGUMENT

The $57,439 Paid To Both Taxpayers by the Executrix of the Estate of John Hedges in Satisfaction of Their Claims for Dividends Erroneously Paid To John Was Taxable Income To Them under Section 22(a) of the Internal Revenue Code in the Year of Receipt, 1944

The single question in this case is whether the $57,439 which both taxpayers recovered from the estate of John Hedges in satisfaction of their claims for the dividends received by John from stock which would have passed to the taxpayers but for his wrongful appropriation was, as we contend, taxable income under Section 22(a) of the Code, (Appendix, *infra*). The basis of the Tax Court's holding was that the period of administration of Kitty Hedges' estate was, under Section 29.162-1 of Regulations 111 (Appendix, *infra*),[2] still open as of

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[2] In its opinion the Tax Court refers to Section 29.161-1 of Regulations 111. It is clear, however, that this is an error, that the Section of the Regulations which the Tax Court is referring to is Section 29.162-1.

February 1, 1944, when John Hedges, Kitty's husband and administrator of her estate, died; that John received the dividends from the wrongfully appropriated Sunshine Mining Company stock for the years 1927 through 1944 as a fiduciary under Section 161(a) (3) of the Code (Appendix, *infra*); and that since they were taxable to John in his fiduciary capacity and not deductible under Section 162(c) of the Code (Appendix, *infra*) except for 1944, they were not thereafter taxable to the taxpayers when finally distributed to them. (R. 59-60.) We shall show that the decision of the Tax Court is based upon an erroneous interpretation of Section 29.162-1 of Regulations 111 and that the settlement sums, insofar as they constituted a substitute for dividends, were taxable income to the taxpayers in the year of receipt, 1944.

Insofar as pertinent Section 29.162-1 of Regulations 111 provides:

> The period of administration or settlement of the estate is the period required by the executor or administrator to perform the ordinary duties pertaining to administration, in particular the collection of assets and the payment of debts and legacies. It is the time actually required for this purpose, whether longer or shorter than the period specified in the local statute for the settlement of estates. If an executor, who is also named as trustee, fails to obtain his discharge as executor, the period of administration continues up to the time when the duties of administration are complete and he actually assumes his duties as trustee, whether pursuant to an order of the court or not. * * *
>
> * * * * *

The Tax Court interpreted this section as meaning that the period of administration of Kitty Hedges' estate did

not close for tax purposes when her husband John, was discharged as administrator on October 4, 1924, even though all the ordinary duties of administration had been completed. (R. 59-60.) Obviously such was not within the contemplation of the Commissioner in drafting this Section of Regulations 111. The Regulations are not based upon the premise that administrators will breach their fiduciary obligations, and the rectification of a breach is not one of the "ordinary duties pertaining to administration" The "time actually required" to perform "the ordinary duties pertaining to administration," within the meaning of Section 29.162-1, does not include the time necessary for administrators to seek redress from themselves for breaches of their fiduciary obligations. The Regulations cannot reasonably be construed as providing for extension of the "period of administration" in the situation here, and the majority of the Tax Court erred in so interpreting it.

One situation contemplated by the Regulations is illustrated by *Chick* v. *Commissioner,* 166 F. 2d 337 (C.A. 1st), certiorari denied, 343 U.S. 845.[3] See also *Williams* v. *Commissioner,* 16 T.C. 893; *Stewart* v. *Commissioner,* 16 T.C. 1; *Roebling* v. *Commissioner,* 18 T.C. 788; *Brown* v. *Commissioner,* 19 T.C. 87. In the *Chick* case, *supra,* the administration of the estate was dry and sterile, without purpose (other than tax saving) as of the tax year in question. The administrators had simply failed to close the estate's account with the local probate court and obtain a discharge, and did so for the purpose of preserving the estate as an entity for tax purposes. As the court there pointed out (p. 341), it was in the interest of a uniform tax system that Congress

[3] Cf. *Frederick* v. *Commissioner,* 145 F. 2d 796 (C.A. 5th).

granted to the Commissioner the authority to determine that the period of administration had closed in that type of situation, thereby thwarting attempts by administrators or executors to continue it for tax purposes. And it concluded that the period of administration had ended, notwithstanding that the administrators had not been discharged.

In the instant case, not only had John T. Hedges performed all his "ordinary duties pertaining to administration" of the estate of his deceased wife, but he also had been discharged as administrator by the state court as of October 4, 1924. Thus, it is clear that under Section 29.162-1 of Regulations 111 the period of administration for tax purposes had terminated as of that date. It follows that John did not receive the dividends in question during the period of administration and, thus, that he was not taxable as administrator of his wife's estate under Sections 161 and 162 of the Code.

The taxpayers argued in the court below that John was a constructive trustee of the stock and dividends in question here. But even if he were a constructive trustee, he nevertheless would not be classified as a fiduciary for purposes of Sections 161 and 162 of the Code. In *Stoddard* v. *Eaton,* 22 F. 2d 184 (Conn.), the court observed that Congress did not use the word "trust" in Section 219 of the early Revenue Acts (the precursors of Sections 161 and 162 of the Internal Revenue Code) as comprehending every type of trust "recognized in equity." Commenting on this fact, the court said (p. 186-187):

> A trust ex maleficio, a resulting trust, or a constructive trust are examples of trusts which do not fit into the frame of the statute. A trust, as therein

> understood, is not only an express trust, but a genuine trust transaction. A revenue statute does not address itself to fictions.
>
> * * * * *

See also *Estate of Peck* v. *Commissioner,* 15 T.C. 788, 796; *Prudence Miller Trust* v. *Commissioner,* 7 T.C. 1245. Thus, under no theory were the dividends in question taxable to John T. Hedges as a *fiduciary* for purposes of Sections 161 and 162 of the Code.

It seems plain that the dividends paid to John were not properly taxable to him as an individual although he did in fact pay tax on them in some of the years that he received them. The dividends were not his and he had no legal right whatever to them. He did not receive them with the taxpayers' knowledge or consent, either freely given or enforced. Thus, John's position was essentially the same as that of Wilcox, in *Commissioner* v. *Wilcox,* 327 U.S. 404, who embezzled money without the consent of the owner and who was held not taxable upon it. Like Wilcox, John too was a wrongdoer, a tort-feasor, who not only was under an unqualified duty or obligation to pay over the money to another, but had no semblance of a bona fide claim of right to the money. In *Rutkin* v. *United States,* 343 U.S. 139, rehearing denied, 343 U.S. 952, the Supreme Court held that one who extorted money from another was taxable on it. The *Wilcox* case, *supra,* was limited to its facts (p. 138) and it was pointed out (p. 138) that the *Rutkin* issue was whether the money extorted from a victim with his consent induced solely by harassing demands and threats of violence was taxable income under Section 22(a). Thus, the majority of the Court appears to have distinguished the two cases on the basis of whether the money wrong-

fully obtained was gotten from the true owner with his knowledge and involuntary consent. Here, as already shown, taxpayers neither knew of, nor gave their consent to, the appropriation or "embezzlement" of their dividends, and, accordingly, we think that *Wilcox* should be controlling and that John was not properly taxable on the dividends.

But even if the view were to be taken that the dividends were properly taxable to John, that still would not alter the fact that the amounts taxpayers received in 1944 constituted income to them in that year. What taxpayers received from the estate of John, aside from the stock itself, which the Commissioner has not attempted to tax, were sums in settlement of their claims—sums which were a substitute for the dividends which they would have received in prior years but for John's wrongful action.[4] The sums were thus gain to taxpayers on which they paid no tax and on which they were not taxable at any previous time. They were on a cash receipts basis (R. 51) and in previous years had not only not received the dividends but were not even aware that they had a claim to them.

That they were taxable on the amounts representing dividends in 1944, the year in which they were received, follows from *United States* v. *Safety Car Heating Co.*, 297 U.S. 88. In that case, the taxpayer sued for infringement of a patent and ultimately recovered profits received by the infringer during the period of infringement. The Supreme Court held that the profits constituted taxable income in 1925, the year taxpayer's right to receive them first accrued, even though the profits

[4] The Tax Court stated in its opinion (R. 58) that taxpayers' claims were "for the stock which belonged to them as heirs of Kitty and for the dividends received on that stock * * *."

were actually earned in prior years. Similarly, in *H. Liebes & Co.* v. *Commissioner,* 90 F. 2d 932, this Court held that sums recovered by a taxpayer representing profits of 1891, 1892, and 1893 constituted taxable income in the year of receipt, the fiscal year ended January 1, 1930, if the taxpayer was on the cash basis, and, if on the accrual basis in the year of accrual, which also was the fiscal year 1930. See also *Hort* v. *Commissioner,* 313 U.S. 28; *Mathey* v. *Commissioner,* 177 F. 2d 259 (C.A. 1st); *Durkee* v. *Commissioner,* 162 F. 2d 184 (C.A. 6th). If sums representing profits of prior years are taxable to the one who had the right to them in the year when his right to the profits first became fixed, if on the accrual basis, or when the profits were received if on the cash basis, it must follow *a fortiori* here that the amounts representing dividends of prior years are taxable to these taxpayers on the cash basis in the year they actually received them.

The fact that John included some of the dividends here in question in his income in the years in which he received them does not relieve the taxpayers of paying tax on the income realized by them. John's payment of tax as to part of the dividends was in no sense a payment of tax on behalf of the taxpayers. Even if John was properly taxable on the dividends it would have been because he realized economic value from them. (*Rutkin, supra,* p. 137.) The tax paid by virtue of one person's economic gain is, however, no substitute for the tax due from another person on his gain. It often happens that tax is paid by different persons on the same amounts, such as on the income of a corporation distributed to its stockholders as dividends. It follows, therefore, that when the taxpayers in the instant case recover sums

which were the equivalent of dividends erroneously paid to John over a seventeen-year period, they were taxable to them in the year of receipt, 1944.

CONCLUSION

In view of the foregoing, the judgment of the Tax Court should be reversed.

Respectfully submitted,

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July 1953.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so emplpoyed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1946 ed., Sec. 41.)

Sec. 42. Period in Which Items of Gross Income Included.

(a) [As amended by Section 114, Revenue Act of of 1941, c. 412, 55 Stat. 687, and Section 134 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued only by reason of the death of the taxpayer shall not be included in computing net income for the period in which falls the date of the taxpayer's death.

* * * * *

(26 U.S.C. 1946 ed., Sec. 42.)

Sec. 161. Imposition of Tax.

(a) *Application of Tax.*—The taxes imposed by this chapter upon individuals shall apply to the income of estates or of any kind of property held in trust, including—

* * * * *

(3) Income received by estates of deceased persons during the period of administration or settlement of the estate; and

* * * * *

(26 U.S.C. 1946 ed., Sec. 161.)

Sec. 162. Net Income.

The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

* * * * *

(b) [As amended by Section 111 (b) of the Revenue Act of 1942, *supra*] There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the legatees, heirs, or beneficiaries, but the amount so allowed as a deduction shall be included in computing the net income of the legatees, heirs, or beneficiaries whether distributed to them or not. As used in this subsection, "income which is to be distributed currently" includes income for the taxable year of the estate or trust which, within the taxable year, becomes payable to the legatee, heir, or beneficiary. Any amount allowed as a deduction under this paragraph shall not be allowed as a deduction under subsection (c) of this section in the same or any succeeding taxable year;

(c) In the case of income received by estates of deceased persons during the period of administration or settlement of the estates, and in the case of income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated, there shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year, which is properly paid or credited during such year to any legatee, heir, or beneficiary, but the amount so allowed as a deduc-

tion shall be included in computing the net income of the legatee, heir or beneficiary.

* * * * *

(26 U.S.C. 1946 ed., Sec. 162.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.42-1. *When Included In Gross Income.*—(*a*) *In general.*—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. * * * If a person sues in one year on a pecuniary claim or for property, and money or property is recovered on a judgment therefor in a later year, income is realized in the later year, assuming that the money or property would have been income in the earlier year if then received. This is true of a recovery for patent infringement. * * *

Sec. 29.162-1. *Income of Estates and Trusts.*— * * *

The income of an estate of a deceased person, as dealt with in the Internal Revenue Code, is therein described as received by the estate during the period of administration or settlement thereof. The period of administration or settlement of the estate is the period required by the executor or administrator to perform the ordinary duties pertaining to administration, in particular the collection of assets and the payment of debts and legacies. It is the time actually required for this purpose,

whether longer or shorter than the period specified in the local statute for the settlement of estates. If an executor, who is also named as trustee, fails to obtain his discharge as executor, the period of administration continues up to the time when the duties of administration are complete and he actually assumes his duties as trustee, whether pursuant to an order of the court or not. * * *

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